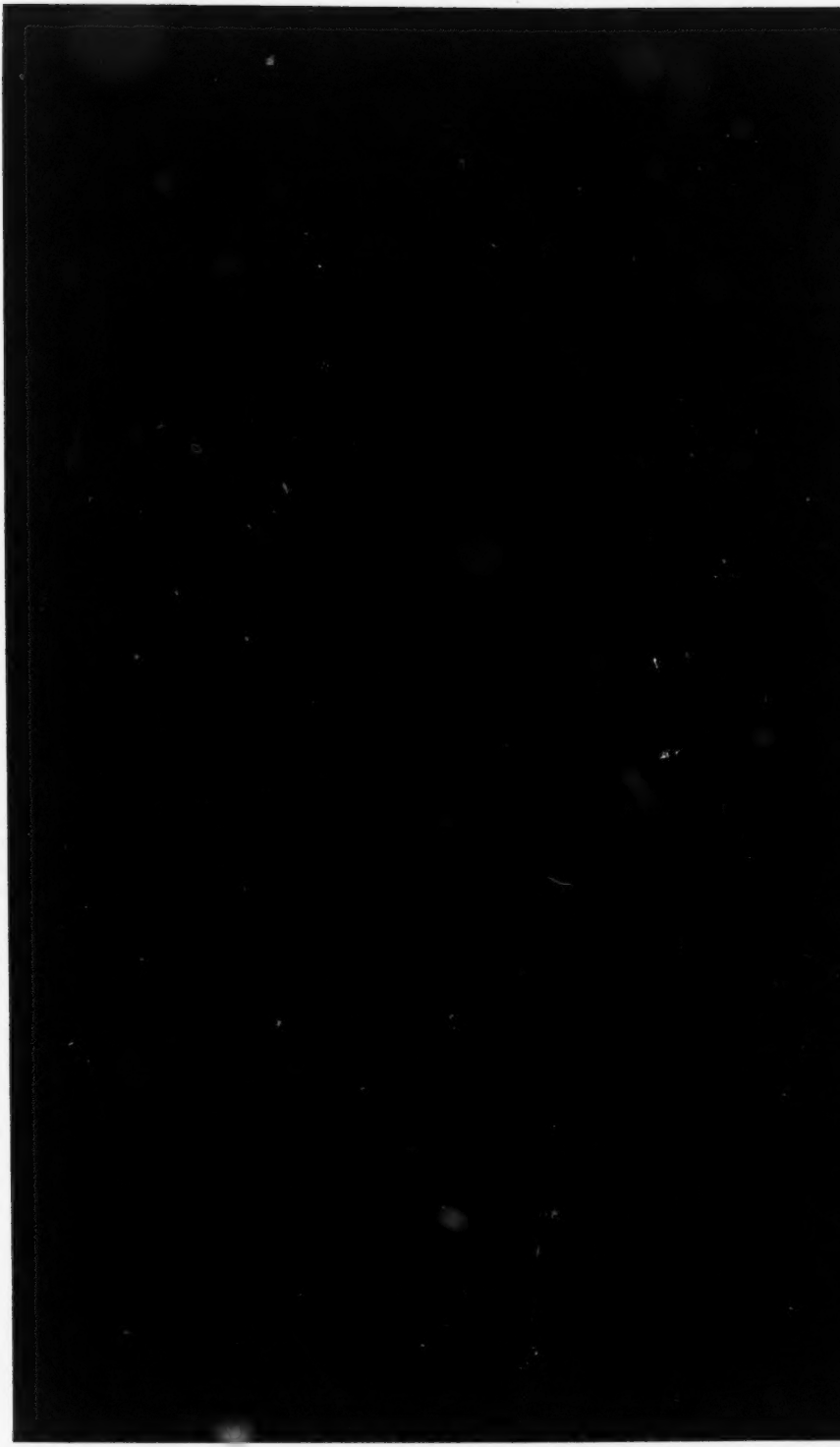

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In the Supreme Court of the United States

OCTOBER TERM, 1951

No. 614

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE, HARRIET H. BELCHER, and LILLIE S. WEGEFORTH, *Petitioners*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 64-98), together with the concurring opinion (R. 98-101), and the dissenting opinion (R. 102-117), is reported at 13 T. C. 984. The opinion of the Court

of Appeals (R. 250-254) is reported at 192 F. 2d 785.

JURISDICTION

The judgment of the Court of Appeals was entered on November 5, 1951. (R. 255.) A petition for rehearing was filed on December 4, 1951, and was denied on January 3, 1952. (R. 256.) A petition for a writ of certiorari was filed on February 25, 1952. The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED

Section 115 (a)(1), Internal Revenue Code, defines a taxable dividend as a distribution by a corporation out of its earnings or profits accumulated after February 28, 1913. Section 115 (b), among other things, provides that earnings or profits accumulated before March 1, 1913, may be distributed tax-free after the earnings and profits accumulated after that date have been distributed.

The question is whether, in the case of a corporation having a deficit on February 28, 1913, the Court of Appeals was correct in construing Section 115 (a)(1) so that all earnings accumulated after that date were available for distribution as taxable dividends, without diminution because of the pre-existing deficit.

STATUTES INVOLVED

The applicable provisions of the statutes involved are set forth in the Appendix, *infra*, pp. 15-18.

STATEMENT

During the taxable years 1938, 1939, and 1940, the taxpayers, who were stockholders of the J. D. and A. B. Spreckels Company (referred to as Spreckels Company), received certain distributions from that company. (R. 67.) The extent to which those distributions are taxable as dividends constitutes the issue for decision. The parties below stipulated how much of the distributions in each year were to be taxed as dividends, depending on how the Tax Court resolved the three issues presented to it for decision, in any combination. (R. 23, 40-55.) Supplemental stipulations were also filed to cover the facts peculiar to each of the taxpayers. (R. 62-64, 147-150, 184-187, 203-204, 233-235.)

The only question on review below related to the Tax Court's decision on issue 2, namely, whether the operating deficits of Oceanic Steamship Company and Kilauea Sugar Plantation Company (wholly owned subsidiaries of the Spreckels Company) as of March 1, 1913, must be restored by subsequent earnings or profits in determining the amount of earnings or profits available for dividends. (R. 23.) The resolution of this question, the facts of which were also stipuated (R. 31-38), was relevant to determine what taxable dividends the Spreckels Company received from these subsidiaries in prior years and how much were the earnings and profits it inherited on the tax-free

liquidation of Oceanic Steamship Company on November 18, 1936. These matters, in turn, affected the amount of the earnings and profits of the Spreckels Company available for the distribution of taxable dividends during the taxable years.

The Tax Court (R. 69-85), with Judges Disney, Arnold and Opper dissenting (R. 102-117), held that the March 1, 1913, deficit of these subsidiaries had to be restored by subsequent earnings before there would be earnings or profits available for the distribution of taxable dividends. The Court of Appeals reversed, holding that the amount of a corporation's earnings accumulated after March 1, 1913, and available for distribution as taxable dividends, was not affected by a pre-existing deficit (R. 250-254.)

ARGUMENT

1. The decision of the Court of Appeals is correct. In describing what corporate distributions should be taxed to the shareholders as dividends, i.e., as ordinary income, Code Section 115 (a)(1) (Appendix, *infra,* p. 17), defines the term "dividend" as any distribution out of the corporation's "earnings or profits accumulated after February 28, 1913." And Section 115 (b) (Appendix, *infra,* p. 17), contains a conclusive presumption to the effect that all distributions are made by a corporation out of its "most recently accumulated earnings or profits," to the extent that such accumulations exist. The Court of Appeals properly held

(R. 250-254) that Congress meant precisely what the statute says in Section 115 (a)(1), namely, that if earnings have been accumulated by a corporation after February 28, 1913, they constitute the source from which taxable dividends are deemed to have been distributed.

The taxpayers' position, that if a corporation possessed a deficit on March 1, 1913, its post-1913 earnings must first be devoted to eradicating that deficit before there can be any earnings or profits available for distribution as taxable dividends, was rightly rejected by the Court of Appeals. Since the taxpayers contend that a corporation which had a deficit on March 1, 1913, can possess no accumulated earnings or profits after that time unless the accumulations are measured from the very inception of its corporate existence, and since the statute, on the contrary, refers only to what has been accumulated after February 28, 1913, the taxpayers' argument is in plain contradiction of the clear legislative language. If Congress, in the case of a corporation possessing a deficit on March 1, 1913, had intended that the measure of its accumulated earnings, as of any subsequent year, should be determined by reference to its earlier, pre-1913 deficit, the statute never would have contained the phrase "accumulated after February 28, 1913," but would merely have referred to the "accumulated earnings or profits."

The legislative history of the statute and the

decisions of this Court fully confirm the lower court's conclusion that there is no reason for departing from the precise terms of the statute. The Income Tax Act of 1913, c. 16, 38 Stat. 114, passed shortly after the adoption of the Sixteenth Amendment to the Constitution and levying a tax on income accruing after March 1, 1913, defined income (Section II B) to include dividends, but did not specify what the word "dividend" meant. In *Lynch* v. *Hornby,* 247 U. S. 339, it was ruled that under the 1913 Act a corporate distribution, made after March 1, 1913, constituted taxable income to the shareholders even though the dividend had been paid out of corporate profits earned prior to the adoption of the Sixteenth Amendment; the Court found no constitutional obstacle to prevent Congress from taxing such distributions as ordinary income to the distributees. However, while *Lynch* v. *Hornby* was still pending in the lower courts, Congress, by Section 2 (a) of the Revenue Act of 1916 (Appendix, *infra,* p. 16), incorporated a provision which limited dividend income to distributions out of "earnings or profits accrued since" March 1, 1913, and, by Section 1211 of the Revenue Act of 1917, c. 63, 40 Stat. 300, added Section 31 (a) and (b) to the 1916 Act, subsection (a) defining a dividend in terms of distributions from earnings and profits accrued since March 1, 1913, and subsection (b) providing that "nothing herein shall be construed as taxing any earnings or profits

accrued prior to" March 1, 1913, but that such earnings could be distributed exempt from tax "after the distribution of earnings and profits accrued since" March 1, 1913, had been made, and also stating that all corporate distributions "shall be deemed to have been made from the most recently accumulated undivided profits or surplus * * *."

The difference thus drawn in the 1916 Act and in the 1917 amendment between corporate accumulations before and after March 1, 1913, while not required by the Sixteenth Amendment, was stated in *Lynch* v. *Hornby, supra,* p. 346, to be a Congressional "concession to the equity of stockholders." From that time on, however, in all succeeding Revenue Acts and in the Internal Revenue Code, despite other changes in the definition relating to dividends, Congress has not only provided that distributions made out of earnings and profits accumulated *prior* to March 1, 1913, *should not* be taxed as dividends, but it has also specifically provided that distributions out of earnings and profits accumuated *after* that date *should be* taxed as dividends to the distributees. Cf. *Helvering* v. *Credit Alliance Corp.,* 316 U. S. 107, 111. In *Helvering* v. *Canfield,* 291 U. S. 163, 168, referring to the statutory provisions there involved, similar to those embodied in Code Section 115 (a) and (b), the Court said that they—

> disclose a single purpose and are to be construed in harmony with each other. They show that the Congress was careful to arrange its plan so that the right to receive, free of tax, a distribution of surplus accumulated prior to March 1, 1913, *should not be exercised in such a fashion as to permit profits accumulated after that date to escape taxation.* * * * (Italics added.)

The fact that Congress was intent on taxing to the stockholders all post-1913 earnings when distributed was reiterated in *Foster* v. *United States,* 303 U. S. 118, 120-121.

While Congress, which was constitutionally empowered to tax all corporate earnings when distributed, regardless of when the earnings had been accumulated (*Lynch* v. *Hornby, supra*), created a limited, specific exemption in Section 115 (b) with respect to the stockholder's supposed "equity" in corporate earnings accumulated prior to March 1, 1913, there was no reason why it should have felt impelled to grant a much broader exemption in the case of a corporation having a deficit on that date, or extend a guarantee that such a deficit should be restored before subsequent earnings would be taxed when distributed. No such exemption was intended or can be read into Section 115 (a). In the *Canfield* case, *supra,* where a portion of the surplus existing on March 1, 1913, was later dissipated by

operating losses, the Court, holding that Congress did not intend that the March 1, 1913, surplus should remain inviolate as a source of tax-free distributions, observed (p. 168) that the stockholders' "equity [in the March 1, 1913, surplus] is not apparent when those profits had been lost in whole or in part * * *." Here, where there was a deficit, the stockholder's equity in a nonexistent surplus is even less apparent.

2. There is no conflict in decisions. *Willcuts* v. *Milton Dairy Co.*, 275 U. S. 215, on which the taxpayer relies (Br. 16-18), is not opposed to the decision below, not even in principle. The issue there concerned the meaning of the statutory phrase "Paid-in or earned surplus and undivided profits," which entered into invested capital in computing the excess profits tax credit,[1] and the validity of a Treasury regulation which provided that the computation should be made beginning with the original organization of the corporation.[2] We need not elaborate on the obviously sound reasons which were referred to in the opinion (pp. 218-219) as compelling the conclusion that Congress there intended that prior deficits must be taken into account in computing the amount of the corporation's "undivided profits" existing at the beginning of the year for purposes of the excess profits tax

[1] Section 326 (a), Revenue Act of 1918, c. 18, 40 Stat. 1057.

[2] Article 838, Treasury Regulations 45 (1920 ed.), promulgated under the Revenue Act of 1918.

credit, or dwell on the distinctly different Congressional purpose represented by the different statutory provisions here involved. It is sufficient to observe that the statute there, which contained no other point of reference, was drafted so as to encompass the entire corporate history. Here, on the contrary, Section 115 (a)(1), as we have seen, makes February 28, 1913, the date from which the accumulation of earnings is to be measured. The *Milton Dairy Co.* case, accordingly, cannot be considered as even remotely supporting the taxpayers' contention that the reference to February 28, 1913, should be read out of Section 115 (a)(1).

Helvering v. *Canfield,* 291 U. S. 163, on which the taxpayers also rely (Br. 18-20), far from being opposed to the decision below, is in full harmony with the lower court's conclusion. There, in interpreting the statutory language which corresponds to Code Section 115 (b), which provided for the distribution to the shareholders, free of tax, of earnings accumulated prior to March 1, 1913 (after the distribution of earnings accumulated after that time), the Court held that Congress did not guarantee that a surplus which existed on the crucial date should remain intact for subsequent, tax-free distribution, so that, if the surplus existing on that date was, in fact, diminished by subsequent losses, the source of tax-free distributions would correspondingly be reduced.

Since Congress, despite its express statutory concern with a stockholder's equity where the cor-

poration possessed a surplus on March 1, 1913, did not warrant that this surplus would remain intact for subsequent, tax-free distribution, or intend that future earnings should be devoted to restoring an intervening diminution of this surplus before being considered as a post-1913 accumulation for dividend purposes, it is inconceivable that Congress, despite its lack of any express statutory concern with a corporation possessing a deficit on March 1, 1913, should have simultaneously intended that the subsequent earnings of such a corporation should first be devoted to its prior deficit before being considered as a post-1913 accumulation available for distribution as a taxable dividend.

The *Canfield* case thus illustrates that, except to the extent that a limited exemption was made in Section 115 (b), all corporate distributions from earnings accumulated after February 28, 1913, were to be subject to tax as ordinary income of the stockholder.

Foley Securities Corp. v. *Commissioner,* 106 F. 2d 731 (C. A. 8th), on which the taxpayers further rely (Br. 20-22) as establishing a conflict in principle, is also not opposed to the decision below in any respect. That case did not involve a March 1, 1913, deficit. It merely held that where a deficit was incurred after that time, such a deficit had to be taken into account in determining the amount of earnings and profits accumulated after March 1, 1913. If that case has any bearing here, it merely

illustrates that the statute means what it says when it speaks of "earnings or profits accumulated after February 28, 1913," for any deficit occurring subsequent to that date necessarily determines how much of the later profits can be considered as having been accumulated after the critical date. Conversely, however, a deficit incurred before February 28, 1913, has nothing to do with the amount of earnings accumulated after that time.

3. The taxpayers make an oblique suggestion that the decision below is infected with constitutional invalidity. (Br. 22-26.) The argument appears to be that a tax on the stockholder's receipt of a corporate distribution at a time when the corporation's capital may be impaired is not a tax on income (within the meaning of the Sixteenth Amendment to the Constitution), but is rather a direct tax which would require apportionment under Section 2, Clause 3, and Section 9, Clause 4 of Article I of the Constitution. It may be noted, at the outset, that if the taxpayers' argument possessed any merit, it would require the invalidation of Code Section 115 (a)(2) for, ever since 1936, Congress has expressly provided that distributions out of the corporation's earnings of the current year are to be taxed as dividends, notwithstanding that the corporation may possess an impairment of capital at that time.

The constitutional contention, however, is devoid of merit. As *Lynch* v. *Hornby,* 247 U. S. 339,

illustrates, Congress may tax as income to the shareholders the distribution of corporate earnings, no matter when those earnings inured to the corporation. Regardless of whether the corporation's capital remains intact, the taxation of the stockholder with respect to distributions made to him cannot be regarded as a direct tax, for the stockholder is not being taxed on his stock, which he continues to hold intact. He is only being taxed with respect to realized gains inuring to him as a result of his continued ownership of such stock. A tax on such gain is not a direct tax requiring apportionment. Cf. *United States* v. *Phellis,* 257 U. S. 156, 171-172; *Taft* v. *Bowers,* 278 U. S. 470, 483-484; *Koshland* v. *Helvering,* 298 U. S. 441; *United States* v. *Safety Car Heating Co.,* 297 U. S. 88. What the taxpayers are really contending for is a constitutional rule requiring Congress to restore to them the "equity" which they would have possessed on March 1, 1913, if the corporation had not suffered losses and an impairment of its capital before that time. No such guarantee was imposed by the Sixteenth Amendment. See *Lynch* v. *Hornby, supra; Helvering* v. *Canfield,* 291 U. S. 163.

CONCLUSION

The decision below is correct. There is no conflict in decisions, and no other reason appears which would call for granting the petition for a writ of certiorari. The petition, accordingly, should be denied.

Respectfully submitted,

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MARCH, 1952

APPENDIX

INTERNAL REVENUE CODE:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U. S. C. 1940 ed., Sec. 22.)

(Sec. 22 (a) of the Revenue Acts of 1938, c. 289, 52 Stat. 447; 1936, c. 690, 49 Stat. 1648; Sec. 213 (a) of the Revenue Acts of 1926, c. 27, 44 Stat. 9; and 1918, c. 18, 40 Stat. 1057, and Sec. 2 (a) of the Revenue Act of 1916, c. 463, 39 Stat. 756, as amended by Sec. 1200 of the Revenue Act of 1917, c. 63, 40 Stat. 300, contain provisions which, as they relate to the issue of this case, are substantially similar to the above quoted portion of Sec. 22 (a) of the Internal Revenue Code.)

Revenue Act of 1916, c. 463, 39 Stat. 756:

> Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided,* That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.
>
> * * * * *

INTERNAL REVENUE CODE:

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113.

* * * * *

(26 U. S. C. 1940 ed., Sec. 115.)

(Sec. 115 (a) and (b), Revenue Acts of 1938 and 1936 are identical. Sec. 201 (b), Revenue Acts of 1926, 1918, and Sec. 31 (b), Revenue Act of 1916, as added by Sec. 1211, Revenue Act of 1917, are, as they relate to the issue of this case, substantially similar to Section 115 (b), Internal Revenue Code.)

Revenue Act of 1926, c. 27, 44 Stat. 9:

> Sec. 201. (a) The term "dividend" when used in this title (except in paragraph (9) of subdivision (a) of section 234 and paragraph (4) of subdivision (a) of section 245) means any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings or profits accumulated after February 28, 1913.
>
> * * * * *

(Secs. 201 (a), Revenue Act of 1918, and 31 (a), Revenue Act of 1916, as added by Sec. 1211, Revenue Act of 1917, as they relate to the issue of this case, are substantially similar to Section 201 (a), Revenue Act of 1926, quoted above.)

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1951

No. 614

GRACE H. KELHAM, LEILA H. NEILL, ELLIS M. MOORE, HARRIET H. BELCHER and LILLIE S. WEGEFORTH,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

REPLY BRIEF FOR THE PETITIONERS.

The Commissioner has not attempted to answer our argument (Br. p. 30) that section 201(d) of the Acts of 1924 and 1926, continued as section 115(d) of the Acts of 1928, 1932 and 1934, makes it clear beyond question that unless a corporation has "earnings or profits" it

cannot have "earnings or profits accumulated after February 28, 1913." The sections referred to provide that if a distribution is not out of "earnings or profits" it reduces the basis of the stock. The Congressional Committee Reports accompanying the Act of 1924 (Br. p. 26) make it clear that the basis of the stock is reduced because the distribution is a distribution of capital. On May 22, 1926 the Spreckels Company received a distribution of $1,558,319.04 from Oceanic. (R. 34.) On that date Oceanic had "earnings or profits" of $1,334,677.57. (R. 34.)[1] One of the questions involved in this case is whether the sum of $223,641.47 by which this distribution exceeded the available earnings or profits of Oceanic increased the earnings or profits of the Spreckels Company available for dividends. The effective Revenue Act was the Act of 1926. Section 201(d) of that Act provided that if the distribution is not out of "earnings or profits" it reduces the basis of the stock. This distribution was not out of "earnings or profits" to the extent of $223,641.47. Accordingly, the Spreckels Company was required to reduce the basis of the Oceanic stock by that amount. Therefore, to that extent this distribution was a distribution of capital and did not increase the earnings or profits of the Spreckels Company. Therefore the decision

[1]Issue number 1 was decided in favor of petitioners; therefore, columns 1 and 3 of this schedule are the two columns now material. Column 1 shows the amount of "earnings or profits" available. Column 3 shows what the Commissioner contends are the "earnings or profits accumulated after February 28, 1913"—that is to say, without the restoration of the impairment of capital existing on March 1, 1913.

below is obviously in error in so far as this distribution is concerned.

The decision below is also in error with respect to the amount of the earnings or profits of Oceanic transferred to the Spreckels Company upon the liquidation of Oceanic in 1936. As we have shown, it is clear that under the Acts of 1924, 1926, 1928, 1932 and 1934 a corporation cannot have "earnings or profits accumulated after February 28, 1913" unless it has "earnings or profits." It therefore could not make a distribution which constituted a dividend without having "earnings or profits." The definition of the term "dividend" was retained in the 1936 and later Acts as section 115(a)(1), with only the addition of section 115(a)(2) which provided that a distribution out of earnings or profits of the current year was also to be regarded as a dividend. This addition and the change in section 115(d) which it necessitated (Br. p. 32) cannot affect the meaning of the words which were carried over in identical form from section 115(a) of the earlier Acts and incorporated verbatim as section 115 (a)(1) of the later Acts. Identical words cannot have changed their meaning. Indeed, the Commissioner does not contend that they have.

The Commissioner does not attempt to answer the foregoing argument, either with respect to the distribution made by Oceanic prior to 1936 or the liquidating distribution of Oceanic in 1936. It is a fair presumption that he has been unable to do so. Petitioners believe that this argument is controlling and that the Court of Appeals

erred in holding that the impaired capital of Oceanic and Kilauea caused by pre-1913 operating losses need not be restored by subsequent earnings or profits in the determination of the amount of earnings or profits available for taxable dividends.

The only question involved, therefore, is whether the petitioners have been able to show that their petition for a writ of certiorari should be granted. The petitioners rely on the reasons advanced in their petition and the brief in support thereof. Reliance was there placed in part on *Willcuts v. Milton Dairy Co.*, 275 U.S. 215, as establishing a conflict in decisions. (Pet. p. 9, Br. pp. 16-18.) We quoted this Court's statement that "it is a prerequisite to the existence of 'undivided profits' as well as a 'surplus', that the net assets of the corporation exceed the capital stock." Although this case dealt with the determination of "undivided profits" for excess profits tax purposes, the principle expressed is equally applicable to the determination of "earnings or profits" for income tax purposes. It has frequently been cited as authority for the proposition that "earnings or profits" cannot exist until impaired capital has been restored. Indeed, Congress itself has treated the term "undivided profits or surplus" as synonymous with "earnings or profits." In section 1211 of the Act of 1917 (c. 63, 40 Stat. 300, 336, adding section 31(b) to the Act of 1916, Appendix, *infra*, p. i) Congress provided that all corporate distributions "shall be deemed to have been made from the most recently accumulated *undivided profits or surplus*," and

then added "but nothing herein shall be construed as taxing any *earnings or profits* accrued prior to March first, nineteen hundred and thirteen * * *." Because of the interchangeability of these terms the decision of this Court in the *Milton Dairy* case is direct authority for petitioners' contention that where capital is impaired, "earnings or profits" cannot exist. The decision of the Court below is seen to be squarely in conflict with the principle of the decision of this Court in the *Milton Dairy* case.

With respect to the constitutional question which we have raised, certain misconceptions in the Commissioner's brief (pp. 12-13) may be briefly referred to. The Commissioner argues that if petitioners' position possesses any merit it would require the invalidation of section 115(a)(2), which taxes as a dividend a distribution from the earnings of the current year notwithstanding an impaired capital. This does not follow. From the point of view of constitutional power to tax, a distinction might well be drawn between a distribution from the earnings of the current year made before the end of the year and before the earnings have been carried to surplus account, and a distribution made in later years after such earnings have been retained and invested in the business of the corporation and devoted to the restoration of impaired capital. But in any event, that question is not involved here. The distributions in this case were a return of the capital invested by the stockholders.

The Commissioner further argues that our constitutional contention is devoid of merit, pointing out that *Lynch v. Hornby*, 247 U.S. 339, held that Congress may tax distributions of pre-1913 earnings. The basis of this decision was that a distribution from *earnings* comes within the meaning of the word income as used in the 16th Amendment. The source of the distribution having been earnings, and not capital, Congress had the power to tax it as income.[2] The case supports our contention that a return to the stockholder of his capital investment is not income.

Finally, the Commissioner contends that a tax on a distribution made while a corporation's capital is impaired is not a direct tax because the stockholder continues to hold his stock and "is only being taxed with respect to realized gains inuring to him as a result of

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[2]In 1916, while the case was pending in the lower courts, Congress, anticipating the decision of this Court and because it desired to exempt from tax a distribution from pre-1913 earnings, limited the definition of a dividend to distributions from earnings accrued since March 1, 1913 (section 2(a), Revenue Act of 1916, c. 463, 39 Stat. 756, Appendix p. i). A year later Congress enacted a provision specifically exempting distributions from pre-1913 earnings (section 1211, Act of 1917, *supra*, p. 4). In order to be consistent it had to retain in the definition of a dividend the limitation to post-1913 earnings. Congress regarded distributions from pre-1913 earnings as similar to capital investment because the stockholder's equity in such earnings had been acquired prior to the imposition of the income tax. Is it conceivable that Congress, in adding a phrase to the statute for the purpose of protecting from tax a distribution from *earnings* which it thought should be *treated as capital*, should have simultaneously intended by the same phrase to subject to tax a distribution from what was *unquestionably capital*? Yet the Commissioner contends that Congress intended to ignore an impairment of capital existing on March 1, 1913.

his continued ownership of such stock." The contention begs the question. It assumes that a return to the stockholder of a portion of his capital investment is a "realized gain."

It is respectfully submitted that a writ of certiorari should issue as prayed for in the petition filed herein.

Dated, San Francisco, California,
April 14, 1952.

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(Appendix Follows.)

Appendix

Revenue Act of 1916, Section 2(a) (39 Stat. 756).

Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: *Provided,* That the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, joint-stock company, association, or insurance company, out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in cash or in stock of the corporation, joint-stock company, association, or insurance company, which stock dividend shall be considered income, to the amount of its cash value.

Revenue Act of 1917, Section 1211 (40 Stat. 300, 336).

Sec. 1211. That Title I of such Act of September eighth, nineteen hundred and sixteen, is hereby amended by adding to Part III six new sections, as follows:

"• • •

"Sec. 31. (a) • • •

"(b) Any distribution made to the shareholders or members of a corporation, joint-stock company, or association, or insurance company, in the year nineteen hundred and seventeen, or subsequent tax years, shall be deemed to have been made from the most recently accumulated undivided profits or surplus, and shall constitute a part of the annual income of the distributee for the year in which received, and shall be taxed to the distributee at the rates prescribed by law for the years in which such profits or surplus were accumulated by the corporation, joint-stock company, association, or insurance company, but nothing herein shall be construed as taxing any earnings or profits accrued prior to March first, nineteen hundred and thirteen, but such earnings or profits may be distributed in stock dividends or otherwise, exempt from the tax, after the distribution of earnings and profits accrued since March first, nineteen hundred and thirteen, has been made. This subdivision shall not apply to any distribution made prior to August sixth, nineteen hundred and seventeen, out of earnings or profits accrued prior to March first, nineteen hundred and thirteen."